Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:LN:POSTF-149002-01
SHwang

date: MAR 29 2002

to: [redacted], Team Manager, LMSB:MCT: [redacted]
Attn: [redacted], Team Coordinator, LMSB:MCT: [redacted]

from: Sandy Hwang, Attorney SH
Joyce M. Marr, Senior Attorney
June Y. Bass, Associate Area Counsel (LMSB)

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subject: [redacted]
EIN: [redacted]
Tax Years: [redacted] **and** [redacted]
Re: Taxable Year of Income Inclusion and Expense Deduction under I.R.C. §§ 451 and 461.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This is in response to your request for advice received on August 20, 2001, as to the proper treatment of reserve accounts in this case. *This memorandum should not be cited as precedent.*

Issue

Whether [redacted] and Subsidiaries (the "Taxpayer"), properly accrued income and expenses, which were based on its estimated reserve accounts, under I.R.C. §§ 451 and 461 with respect to income earned for services rendered during the taxable years ended April 30, [redacted] and April 30, [redacted], to Medicare/Medicaid patients.

Conclusion

In this case, the Taxpayer had two estimated reserve accounts which were based on prior experience. One reserve account, also referred to as the contractual allowance account, was used to offset the Taxpayer's accrued income either as an income exclusion or as a deduction in the year medical services

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were performed. The second reserve account was for the Taxpayer's overbillings or the amounts it expected to pay back, as a refund, to Medicare/Medicaid at the end of a year. Amounts added to this second reserve are deducted.

In general, prior experience or historical data is not a basis for making reasonable estimates and may not be used for accruing items of income and expense. Since both reserve accounts are based on prior experience, the Taxpayer's method of offsetting its taxable income with amounts from these accounts is not a proper method of accrual under I.R.C. §§ 451 and 461. Accordingly, the Taxpayer may not offset its income with the amounts from the contractual allowance account. Further, the Taxpayer may not deduct an estimate of the refund.

Facts[1]

[redacted] ("[redacted]") through its subsidiaries owns, leases, and operates [redacted] hospitals. For the taxable years ending April 30, [redacted] and [redacted], [redacted] and its subsidiaries filed consolidated Federal income returns and used the accrual method of accounting.

A large portion of the Taxpayer's revenues were received from government health care programs including Medicare and Medicaid programs, administered by the state and the Health Care Financing Administration ("HCFA"), a federal agency. Every year, the HCFA enters into a contract with certain insurance companies such as Blue Cross, Mutual of Omaha and Aetna Insurance within each state. These insurance companies act as fiscal intermediaries ("FI"), to pay compensation to the hospitals for medical services performed and administer the rules and regulations of the HCFA within each state. With respect to patients who qualify for financing through the Medicare/Medicaid program, the Taxpayer annually enters into a contractual agreement (the "Contract") with the FI. The Contract entitles the Taxpayer to compensation for services rendered to qualified patients on the basis of "reasonable cost." Reasonable cost is the actual cost incurred by the Taxpayer in rendering the services to the Medicaid/Medicare patients plus a fixed percentage (i.e., [redacted]%) return on equity capital as a profit factor. Thus, the cost of operating the entire hospital,

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[1] Our advice is contingent on the accuracy of the information which you have supplied. If you uncover any information inconsistent with the facts recited in this memorandum, you should not rely on this memorandum, and you should seek further advice from this office.

including depreciation, and other expenses are considered.

The Taxpayer's total compensation for a year cannot be determined until the end of that year for the Contract (the "Contract year"). However, under the Contract, the Taxpayer is reimbursed for its services prior to the end of the Contract year with certain interim or tentative payments. At the beginning of the Contract year, the FI establishes the interim payment rates based partly on the previous Contract year's reimbursements and projected reasonable costs of the current year.

In general, the Taxpayer bills the FI at its customary rates which are higher than the interim rates, knowing that it will be compensated based on the interim rates. The Taxpayer's employees book the revenue related to the services provided to the Taxpayer's financial accounting records on the same day the medical services are provided. When the FI receives the bill, it decides whether the particular service or a certain portion of the service is covered by Medicare/Medicaid. If the FI determines that a service is not covered, the Taxpayer may dispute this determination once it learns of the FI's decision. If the service is covered, the FI sends a payment to the Taxpayer for the services rendered at the interim rates. On average, it takes six months for the FI to provide this amount to the Taxpayer.

While the funds received by the Taxpayer are unrestricted as to use, the Taxpayer is subject to an obligation to repay to the FI all amounts billed and received during the Contract year in excess of the actual reasonable cost incurred during the year as reflected in the Taxpayer's "cost report" which is filed annually with the FI.

The Taxpayer is required by the Contract to submit a cost report to the FI within 90 days after a Contract year ends. The Taxpayer's Contract year does not coincide with the Taxpayer's taxable year. This cost report reflects the Taxpayer's actual costs incurred during its Contract year in rendering medical services to Medicaid/Medicare patients. The cost report must include a certification signed by an officer of the Taxpayer. Upon receipt by the FI, the cost report is subjected to a desk audit. Revisions are made when necessary, and remittance of the balance due the Taxpayer, if any, is made upon settlement of the desk audit. Any refund due the FI, as reflected in the cost report, must be paid by the Taxpayer when the cost report is filed.

For federal income tax purposes, the Taxpayer accrues as income the gross amounts billed at the customary rates rather than the interim rates established by the Contract for services rendered. This income is then offset by an amount in the Taxpayer's reserve account, also known as the contractual allowance account, as an income exclusion or as a deduction.

Since the Taxpayer is compensated based on the interim rates, it does not collect the full amount of its gross billings. The Taxpayer attempts to estimate the portion of its bills it will not collect from the FI. The contractual allowance account is mainly the difference between the higher billing rates and the interim rates. The Taxpayer maintains a contractual allowance account because the Taxpayer may have to wait months after medical services have been performed before it receives a payment from the FI. However, the Taxpayer does not track the amount billed to and paid by the FI on a patient by patient basis for this reserve. Rather, the Taxpayer combines all bills on a monthly basis. Once the Taxpayer receives a payment from the FI, an adjustment is made decreasing the contractual allowance account by the portion of the gross bill that was not paid (gross bill less interim payment). The balance of the contractual allowance account represents the portion of its gross bills that the Taxpayer anticipates will not be paid by the FI or the uncollectible amount.

On a monthly basis, the Taxpayer estimates the amount to be added to the contractual allowance account by using many different methods which are based on prior experience. The two methods primarily used by the Taxpayer are the accounts receivable method and the revenue method. Under the accounts receivable method, at the end of each month the Taxpayer looks at the open accounts in accounts receivable and estimates the amount it expects to collect. The expected collection is compared to the balance sheet reserves and any shortfall or excess is adjusted in that month. Under the revenue method, at the end of each month the Taxpayer estimates the reimbursement it expects to receive for the services the Taxpayer provided in that month. In general, the Taxpayer uses the estimate which results in the largest increase to the contractual allowance account.

In addition, the Taxpayer sets up another reserve account for the amounts it expects to pay back to the FI when the annual cost reports are filed. In cases in which the Taxpayer estimates that the total monthly billings to the FI during the taxable year exceed the actual amount due ("overbillings"), the Taxpayer, at year end, makes an adjustment to decrease gross income by an estimate, based on prior experience, of the amount that will have to be refunded to the FI when it completes, certifies, and files its cost report. Because the Taxpayer keeps records on a patient by patient basis for billing or other purposes, it has the capability of comparing the interim payments it has received with the amount it expects to be owed under the Contract. Thus, the Taxpayer at the end of its taxable year has all the information necessary to readily calculate, with reasonable accuracy, the amount of its compensation under the contract and, consequently, the amount of any refund due the FI. However, for administrative ease it consistently uses an estimate based on experience as a basis for accrual of its liability to make a refund.

ANALYSIS

In this case, the Taxpayer has two reserve accounts: the contractual allowance account and the reserve account for overbillings to the FI. Both reserve accounts are estimates, based on prior experience. In general, prior experience or historical data is not a basis for making reasonable estimates and may not be used in making an estimate of a liability or an expense. See United States v. General Dynamics Corp., 481 U.S. 239 (1987). The remainder of this memorandum will focus on whether the Taxpayer accrued income and expenses properly in the proper taxable year under I.R.C. §§ 451 and 461.

I.R.C § 451 provides rules for determining the taxable year of inclusion for items of gross income. The regulations under I.R.C. § 451 set forth a two-prong test, the all-events test, for the recognition of income for accrual method taxpayers. The first prong is whether all the events have occurred that fix the taxpayer's right to receive the income. All the events that fix the right to receive income occur when 1) the required performance takes place, 2) payment is due, or 3) payment is made, whichever happens first. See Schlude v. Commissioner, 372 U.S. 128 (1963). The second prong of the all-events test is whether the amount of income can be determined with reasonable accuracy. When an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. Treas. Reg. § 1.451-1(a).

In this case, the Taxpayer offset its accrued income by an amount from the contractual allowance account either as an income exclusion or as a deduction in the year services were performed. There is no reason to distinguish between treating the contractual allowance as an income exclusion or deduction since the nature of the contractual allowance does not change the effect upon the taxable income which is the same in either case. Here, the Taxpayer's right to receive compensation accrued under the all events test of I.R.C. § 451 in the taxable year that the medical services were performed. However, since the Taxpayer does not track its bills on a patient by patient basis for purposes of this reserve, the Taxpayer's income, offset by an estimate, does not constitute income accrued with reasonable accuracy. As a result, the Taxpayer must accrue its income at the gross billed amount without the offset.

Because the Taxpayer's method of accruing income by offsetting the contractual allowance against its income is not allowable under I.R.C. § 451, we must determine whether the Taxpayer's expenses or adjustments from the contractual allowance account, along with the second reserve account for overbillings to the FI, would be treated as accrued expenses in the year services were performed under I.R.C. § 461.

I.R.C § 461(a) provides that the amount of any deduction or credit shall be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

The all events test of Treas. Reg. § 1.461-1(a)(2) provides that two requirements must be met before accruing an item of expense. First, to be deducted in a taxable year, the fact of the liability must be determined in that year. Second, for purpose of an expense deduction the amount of the item of deduction must be determined with reasonable accuracy. When a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

Here, the Taxpayer's method of offsetting its accrued income by the estimated contractual allowance account is not a proper method of accrual under I.R.C. § 461. If the Taxpayer tracked or accounted for its patients' bills individually to show the difference between the gross billed amount and the actual (interim) payment received from the FI, the Taxpayer would be able to determine its expenses with reasonable accuracy under the all events test of I.R.C. § 461. The difference is between making an estimate based on past trends verus making an estimate based on actual events. In this case, the actual events would be a review of each patient's bill followed by a determination based on all the facts and circumstances of the expected payment. This review should be performed on each account at some point in the billing and collection process to assure that the proper payment has been received. It appears that Taxpayer had all the information necessary at the end of the year to make a reasonable estimate from the actual events. However, due to the administrative costs, the Taxpayer used estimates based on past experience even though the use of such estimates is contrary to the Service's position. See Rev. Rul. 81-176, 1981-2 C.B. 112. Accordingly, the Taxpayer may not offset its income by the contractual allowance under I.R.C. § 461.

The second reserve account is for when the Taxpayer determines at the end of its taxable year that it has overbilled the FI. A deduction is taken from gross income based only on the Taxpayer's estimate of the probable amount that will have to be refunded to the FI. Such an estimate is no more than an assumption, based on prior experience, that costs incurred in providing services during the taxable year have remained the same as costs incurred in prior years.

In this case, because the end of the taxable year and the end of the Contract year do not coincide, one Contract year ends within the taxable year and another Contract year ends after the taxable year. All of the facts necessary for the calculation of the Taxpayer's actual "reasonable cost" are fixed as to the portion of the Contract year that ends within the taxable year. For the portion of the Contract year ending within the Taxpayer's tax year, the exact amount of any refund due the FI may be determined with reasonable accuracy at the end of the Taxpayer's taxable year. In addition, for the Contract year for which a cost report has not yet been filed, the Taxpayer has all the information necessary at the end of its taxable year to readily calculate, with reasonable accuracy, the amount of its compensation under the contract, and consequently the amount of any refund due the FI. The Taxpayer has records that indicate both its actual costs incurred during the portion of the Contract year that ends after the taxable year and the interim payments accrued during the same period. Therefore, the Taxpayer has the information necessary to calculate, with reasonable accuracy, the amount of any refund based on actual events rather than an amount based on prior experience. Accordingly, the Taxpayer's practice of deducting estimated refunds in the instant case based or past experience does not constitute a proper basis for accrual under the all events test set forth in Treas. Reg. § 1.461-1(a)(2) of the regulations. See Rev. Rul. 81-176, 1981-2 C.B. 112.

Thus, for the portion of the Contact year that ends within the taxable year, the actual amount (as reflected on the cost report that was filed before the end of the taxable year) that must be refunded to the FI is the proper amount that must be accrued by the Taxpayer pursuant to § 461. However, for the portion of a Contract year that ends after the taxable year, since the Taxpayer estimated its deductions attributable to overbillings based on prior experience, these deductions were not properly accrued under the all events test.

This advice has been coordinated with the National Office under the NSAR pre-review procedures and with Health Care ISP. Please call Sandy Hwang at (949)360-3432, if you have any questions.